[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES AND THE REPUBLIC OF ITALY

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON JULY 30, 1985

PREPARED BY THE STAFF

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INTRODUCTION

This pamphlet[1] provides an explanation of the proposed income tax treaty, as modified by the proposed protocol, between the United States and the Republic of Italy ("Italy"). The proposed treaty and proposed protocol were both signed on April 17, 1984. The proposed treaty was amplified by an exchange of notes signed the same day. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty on July 30, 1985.

The proposed treaty replaces an existing income tax treaty between the United States and Italy that was signed in 1955. It also terminates a suspended tax arrangement between the two countries regarding shipping income that was effected in 1926.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model treaty"), and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model treaty"). However, there are certain deviations from those documents.

The first part of the pamphlet summarizes the principal provisions of the proposed treaty and protocol. The second part presents a discussion of issues that the proposed treaty presents. The third part provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in part four by a detailed explanation of the proposed treaty and protocol.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and the Republic of Italy* (JCS-30-85), July 29, 1985

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and Italy are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty provides that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends, interest, royalties, capital gains, and certain other income derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12 and 13). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11 and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit. Italy, however, retains the option to mitigate double taxation by exempting U.S. source income from tax.

The proposed treaty contains a "saving clause" similar to that contained in other U.S. tax treaties. Under this provision, the United States generally retains the right to tax its citizens and residents as if the treaty had not come into effect. In addition, the protocol contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries; that is, the treaty will only be applied to the benefit of taxpayers.

Difference in proposed treaty and model treaties

The proposed treaty differs in certain respects from the existing treaty with Italy, from other U.S. income tax treaties, and from the U.S. model treaty. Some of these differences are as follows:

(1) The United States waives the right to tax U.S. social security payments made to U.S. citizens who are both citizens and residents of Italy. The United States has not in any other case waived the right to tax social security payments that it makes to U.S. citizens. (See discussion under "Issues" below.)

(2) U.S. citizens who are not also U.S. residents are not generally covered by the treaty. The U.S. model does cover such U.S. citizens. However, the United States has rarely been able to negotiate coverage for nonresident citizens.

(3) The proposed treaty generally covers specified Italian taxes that the existing treaty does not cover. The existing treaty does not purport to cover taxes that are substantially similar to the taxes that it does cover. The proposed treaty covers the Italian local income tax. The existing treaty does not cover the Italian local income tax. At the time the existing treaty went into effect, Italian local taxes were not significant.

(4) The proposed treaty covers miscellaneous matters that the existing treaty does not cover. For example, the proposed treaty makes it clear that the United States can tax individuals who renounce their U.S. citizenship even if they become Italian residents. It specifically allows the United States to impose the personal holding company tax, the social security tax, and the accumulated earnings tax.

The proposed treaty covers the U.S. excise tax on insurance premiums. This is a departure from older U.S. tax treaties. The U.S. model and some recent U.S. treaties, such as those with the United Kingdom, France, and Hungary, generally cover this tax.

(5) The proposed treaty defines a number of terms that the existing treaty does not define. In general, it makes it clear that each country includes its continental shelf. The proposed treaty provides for the determination of a single country of residence for individuals. This determination would be of considerable benefit to individuals who are residents of the United States under domestic law but who could avoid most of the consequences of that characterization if they could show that they are residents of Italy under the "tie-breaker rule" of the proposed treaty, and vice versa. In amending the definition of U.S. residence in 1984, Congress contemplated that treaty tie-breaker rules like this one would prevail over the statutory definition.

(6) Under the proposed treaty, there is no determination of a single country of residence for a company that is a resident of both countries under local law. Under the U.S. model treaty, by contrast, a dual resident corporation is automatically considered a resident of the country under whose laws it was first created and is, thus, entitled to only the treaty benefits that other corporate residents of that country receive. Read literally, the treaty might oblige the United States to give double foreign tax credits for taxes that a dual resident corporation pays. (See discussion under "Issues" below.)

(7) The definition of permanent establishment in the proposed treaty is somewhat broader than that in the U.S. model and in some existing U.S. treaties. The principal area in which the proposed treaty departs from the U.S. model is the inclusion as a permanent establishment of a drilling rig or ship that is used for more than 180 days in a 12-month period for the exploration or exploitation of natural resources (rather than the U.S. model's 12 months). (See discussion under "Issues" below.) The existing treaty does not specifically address the question whether a drilling rig is a permanent establishment.

(8) The proposed treaty does not provide investors in real property in the country not of their residence with an election to be taxed on such investments on a net basis. The U.S. model allows such an election. The existing treaty with Italy allows an annual net basis election. Current U.S. law independently provides a net basis taxation election to foreign persons. Italy taxes real property income on a net basis.

(9) The proposed treaty does not contain a definition of the term "business profits," although certain categories of business profits are defined in various articles. Many U.S. treaties, and the U.S. model, define the term business profits to include income from rental of tangible personal property and from rental or licensing of films or tapes. Absence of this definition means that persons who earn such rental or licensing income could be subject to tax on a gross basis, not a net basis, in the source country unless they maintain a permanent establishment there.

(10) The proposed treaty's limits on gross dividend withholding taxes that the country of source may impose differ from those of the U.S. model. The proposed treaty provides for three levels of limitation. These levels are, in general: five percent in the case of dividends paid to a 50-percent corporate owner, 10 percent in the case of dividends paid to a 10-percent corporate owner, and 15 percent in other cases. These limitations contrast with the five percent limit on dividends paid to 10-percent corporate owners and 15 percent limit on other dividends in the U.S. model. Under the existing treaty, by contrast, only 95-percent corporate shareholders are entitled to the 5-percent rate, while other shareholders obtain a 15-percent rate.

(11) The U.S. model treaty allows one country to tax dividends paid by a resident company of the other country from profits of its permanent establishment in the first country constituting 50 percent or more of the company's worldwide income. The proposed treaty allows one country to tax dividends paid by a resident company of the other only when the dividends are (a) paid to a resident of the first country or (b) with respect to a stock holding or other corporate right effectively connected with a permanent establishment or a fixed base in the first country. This variation from the U.S. model has the effect of prohibiting the United States from imposing its "second tier" withholding tax on dividends (see Code sec. 861(a)(2)(B)) paid by any Italian company that in the future earns significant business profits in the United States.

(12) The proposed treaty generally limits the withholding tax at source on gross interest to 15 percent; interest derived by the governments of the countries, by certain government financial institu-

tions, and by individuals on debt-claims guaranteed or insured by the foregoing entities is exempt from source country withholding tax. Under the U.S. model, all interest, by contrast, generally is exempt from source country withholding tax.

Because of the recent repeal (in the Tax Reform Act of 1984) of the U.S. gross withholding tax on interest paid on portfolio indebtedness held by foreign persons, Italian residents generally will receive U.S. source interest on portfolio indebtedness free of U.S. tax in any event. However, U.S. residents generally will be subject to Italian tax (limited to 15 percent by the treaty) on Italian source interest on similar indebtedness.

(13) The proposed treaty allows source country taxation of royalties at rates ranging from five to 10 percent. The U.S. model exempts royalties from source country tax. The existing treaty with Italy generally exempts royalties from source country tax. (See discussion under "Issues" below.)

(14) The existing treaty does not cover gains from the alienation of property, so both the source country and the residence country may tax those gains. The proposed treaty would generally allow source basis taxation only of real property interests and of personal property associated with a permanent establishment or fixed base and not of other gains.

(15) The proposed treaty would allow the source country to tax wages and salaries of residents of the other country only if the payment arises from a source country payor, permanent establishment, or fixed base, or if the recipient is present in the source country for more than 183 days in the fiscal year. Under the existing treaty, a similar source country exemption applies for only 90 days.

(16) The proposed treaty allows source country taxation of independent personal service income on either of two bases: presence in that country for more than 183 days in a calendar year, or regular availability of a fixed base there. The U.S. model treaty does not allow taxation on the basis of days of presence. Under the U.S. model, independent personal service income of a nonresident is taxable only if the nonresident has available a fixed base in the source country. The existing treaty treats income from independent personal services like wage or salary income (described above).

(17) The proposed treaty allows director's fees derived by a resident of one country in his capacity as a member of the board of directors of a company which is a resident of the other country to be taxed in that other country. The U.S. model treaty, on the other hand, treats directors' fees as personal service income or as a distribution of profits. Under the U.S. model treaty (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income.

(18) Under the proposed treaty, a source country may tax income derived by entertainers and athletes from their activities as such only if that income exceeds $12,000 in a fiscal year or the individual is present there for more than 90 days during a fiscal year. Under the U.S. model treaty, entertainers and athletes may be taxed in the source country only if they earn more than $20,000 there during a taxable year. Most U.S. income tax treaties follow the U.S. model rule, but use a lower annual income threshold.

(19) The proposed treaty allows taxation of child support payments only if the payor is entitled to a deduction for the payment in his or her residence country. Even if the payment is deductible, the payment would be taxable only in the country where the recipient resides. The existing treaty does not address child support payments specifically.

(20) The proposed treaty, like the U.S. model, allows residence country taxation of alimony payments. Unlike the model, however, the proposed treaty conditions imposition of residence country tax on a source country deduction for the payment. In addition, unlike the model, the proposed treaty overrides the saving clause for alimony payments. Thus, for example, the United States cannot tax alimony payments that a U.S. citizen makes to an Italian resident who is a U.S. citizen. The existing treaty does not address alimony specifically.

(21) Under the proposed treaty, the salaries of visiting teachers and researchers are exempt from tax in the host country for up to two years. Under the U.S. model, these salaries are subject to the standard rules, which may result in full source country taxation. A number of existing U.S. income tax treaties, including the existing treaty with Italy, provide visiting teachers and researchers with a two-year exemption from source country taxation.

(22) The proposed treaty's exchange of information provision generally follows that of the existing treaty. It contains some significant differences from the U.S. model. The U.S. model treaty provides for the exchange of information relating to taxes of every kind imposed by the two countries. The proposed treaty provides for the exchange of information only as it is relevant to the assessment of taxes covered by the treaty. The U.S. model treaty requires that, upon an appropriate request for information, the requested country obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. It also requires that, where specifically requested by the competent authority of one country, the competent authority of the other country provide the information in the form requested. The proposed treaty does not include these requirements. The proposed treaty, like the U.S. model (and unlike the existing treaty), makes it clear that the appropriate Congressional committees and the General Accounting Office are to have access to information exchanged under the treaty where appropriate.

(23) The proposed treaty's anti-treaty shopping provision (added by the proposed protocol) is less comprehensive than that of the U.S. model treaty and recent U.S. income tax treaties. (See discussion under "Issues" below.)

(24) In notes exchanged at the signing of the proposed treaty and protocol, Italy expressed concern about states of the United States taxing income of Italian companies by use of the "unitary apportionment" method. The United States agreed to reopen discussions with Italy if an acceptable provision on this subject can be devised.

II. ISSUES

(1) Social security

In 1983, Congress imposed a 30-percent withholding tax on one-half of the amount of social security benefit payments to nonresident aliens. The proposed treaty would prevent the United States from taxing U.S. social security payments made to U.S. citizens who are both citizens and residents of Italy. This waiver of taxing jurisdiction is unprecedented: the United States has never before agreed to forego completely its right to tax income that arises in the United States and that is earned by a U.S. person (a term that includes U.S. citizens). The United States frequently waives tax on U.S. source income that is earned by foreigners. The United States sometimes waives tax on foreign source income that is earned by U.S. persons (typically, but not always, through the foreign tax credit). In at least one case, the United States has foregone the primary right to tax some U.S. source income paid to U.S. citizens (in the 1984 French protocol), but the United States has always apparently retained at least a residual right to tax U.S. income of U.S. citizens. The uniqueness of this treaty provision is that it waives all the U.S. right to tax when the United States has both a source claim and a citizenship claim to tax the income. The United States has apparently never recognized dual nationality as reducing in any way the U.S. claim to tax its citizens on a citizenship basis.

One might argue that the waiver of tax on social security payments in this instance is of minor importance, since the waiver would apply to a limited class of individuals. The precedential importance of this treaty provision could be significant, however. If the United States agrees to waive tax on social security payments for U.S. citizens who are both citizens and residents of Italy, it may be difficult to deny equivalent treatment to other countries. In addition, allowing this treatment for social security payments in this treaty could encourage demands for waiver of tax on other types of income by other countries in the future. If the United States once abandons the principle that it has at least a residual right to tax U.S. source income of U.S. persons who reside abroad, it may be difficult to defend that principle in the future, except on an ad hoc basis.

The treaty also prevents the United States from taxing U.S. social security payments made to Italian residents who are not U.S. citizens. The treaty with Canada, to which the Senate consented after enactment of the withholding tax on social security payments to nonresident aliens, contains a similar restriction, so this restriction in the proposed treaty with Italy appears not to present a significant issue.

(2) Dual resident corporations

The proposed treaty presents the possibility of double U.S. foreign tax credits for taxes paid to Italy. Italy determines corporate residence on the basis of corporate activities, while the United States determines corporate residence on the basis of place of incorporation. Therefore, an Italian resident corporation under Italian law may be a U.S. resident corporation under U.S. law; such corporations are known as dual resident corporations. A U.S. corporation is entitled to foreign tax credits for the taxes it pays directly. It is entitled to those credits even if it is a dual resident corporation.

The problem arises if a dual resident corporation pays a dividend to a 10-percent U.S. corporate shareholder. On payment of a dividend from an Italian corporation to a 10-percent U.S. corporate shareholder, the proposed treaty allows the U.S. corporate shareholder to credit its share of the Italian taxes that the Italian resident corporation paid to Italy. (The Internal Revenue Code generally allows 10-percent U.S. corporate shareholders to credit their share of foreign taxes paid by a foreign corporation from which they receive dividends, but that treatment (the "deemed paid credit" or "indirect credit") does not apply to dividends from U.S. corporations.) The proposed treaty does not specifically indicate that the deemed paid credit is unavailable when the payor of the dividend is a dual resident corporation. If the deemed paid credit is available, the payor would credit the Italian taxes it paid, and the payee could credit those same Italian taxes, while possibly excluding 100 percent or 85 percent of the dividend from income by virtue of the dividends received deduction.

The negotiators of the proposed treaty did not intend this combination of double foreign tax credits and dividends received deduction. The language of the proposed treaty, on its face, does not prohibit that result, however. One recent treaty, that between the United States and New Zealand, contains a deemed paid credit provision similar to that of the proposed treaty with Italy but with a crucial exception: U.S. corporate shareholders cannot credit taxes paid by dual resident corporations. The existence of that exception in the New Zealand treaty might lead taxpayers or a court to infer that double foreign tax credits would be available under the proposed Italian treaty. The issue is how to make it clear that the proposed treaty with Italy does not allow double foreign tax credits and to foreclose the possibility of litigation. Committee report language, combined with Treasury's technical explanation, might be adequate to prevent taxpayers from claiming double credits on their tax returns. In some cases, Congressional report language, longstanding Treasury interpretation, and rational inferences from the purpose of the treaty have combined to convince courts to adopt a result that is the only one the parties to the treaty could have meant despite an alternative reading that comported with the language of the treaty itself. (See, e.g., *Marie G. Crerar,* 26 T.C. 702 (1956).)

Government victory in litigation on this issue of double foreign tax credits, however, should not satisfy the Committee as it addresses this issue. The Committee should be certain that the inabil-

ity of taxpayers to claim double foreign tax credits is so clear that taxpayers will suffer fraud penalties if they claim double credits on their returns and then pay the tax actually due on audit. Otherwise, taxpayers may well be willing to claim double credits and then play the audit lottery, wherein they never pay the tax due if an IRS agent does not spot the double foreign tax credit issue, while they pay the tax plus interest and perhaps only a minor penalty if an agent does deny the double credits. A reservation requiring a change in the treaty would clearly achieve the result the committee seeks.

(3) Resourcing rule of the Tax Reform Act of 1984

The Tax Reform Act of 1984 amended the foreign tax credit limitation rules to prevent U.S. persons from treating as foreign source income dividends, interest, and certain other income they derived from a foreign corporation a significant part of whose income arose in the United States. The proposed treaty provides that the United States need credit taxes paid to Italy only "[i]n accordance with and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)" (Article 23, paragraph 2). The proposed treaty also provides that "[f]or purposes of the United States obligation to avoid double taxation with respect to Italian tax under the preceding paragraphs of the Article" by use of the foreign tax credit, any income of a resident of one country (who is not a resident of the other country) that the other country can tax shall be deemed to arise in the country that can tax the income (Article 23, paragraph 4).

The issue is whether the proposed treaty allows the 1984 change to the foreign tax credit limitation to operate as Congress intended. If the 1984 change is a limitation on the foreign tax credit (for the purpose of the treaty provisions listed above), then paragraph 2 of Article 23 would control. In that case, the proposed treaty would not prevent operation of the change since the treaty credit is to be granted "subject to the limitations" of U.S. law. A strong argument for this view is that the 1984 Act amended a Code section (904) that deals only with the foreign tax credit limitation. If, instead, the 1984 change is a source rule for purposes of the proposed treaty, then paragraph 4 arguably would control. In that case, the proposed treaty arguably would prevent operation of the change since that paragraph requires foreign sourcing of certain income that would otherwise be treated as U.S. source income under the 1984 Act rule. The argument for this latter view is that the language in paragraph 4 relates only to the U.S. obligation to credit Italian taxes, and that it means nothing unless it obligates the United States to credit taxes on income that the treaty treats as foreign source income.

Thus, the proposed treaty might make payments from an Italian corporation to a U.S. person Italian source, even if the Italian corporation derived all its income from the United States. That result, if it obtains, would defeat the purpose of the 1984 Code amendment. The Treasury Department interprets the proposed treaty so that it will not override the 1984 amendment. The issue for the Committee is to insure that Committee report language and Treas-

ury's technical explanation clarify the retention of the 1984 change to the Code.

(4) Treatment of drilling rigs as permanent establishments

The proposed treaty defines permanent establishment to include a drilling rig or ship used for the exploration or development of natural resources in a country if it remains there for more than 180 days in a 12-month period. This treatment contrasts with the general 12-month permanent establishment rule of the proposed treaty. In its 1984 report on the income tax treaty with Canada, the Senate Committee on Foreign Relations expressed its view that the offshore activities of contract drillers are, as a general matter, closely analogous to construction activities.[2] The Committee indicated its strong belief that the permanent establishment threshold for drilling contractors should be the same as that provided for enterprises engaged in construction activities.[3] The proposed treaty once again presents the issue whether unequal treatment for drilling rigs and construction activities is appropriate. On the one hand, it might be argued that the United States should not make concessions to developed countries like Italy of the kind typically made to developing countries, especially in light of the Committee's comments just over a year ago. On the other hand, the proposed treaty with Italy was signed before the Committee made the comments described above. Therefore, it may be argued, unequal treatment is appropriate in this isolated case. In addition, it might be argued that this treatment must be viewed in the context of an overall agreement that benefits a broad range of U.S. taxpayers and the United States. Further, the proposed treaty may be an improvement from the existing treaty, which arguably provides no permanent establishment protection for drilling contractors.

(5) Treaty shopping

The anti-treaty shopping provision of the proposed protocol differs significantly from that of the U.S. model treaty. The U.S. model provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses, and this Committee and the Senate have not insisted that treaties conform to the model's language. Nonetheless, the model provision is a standard against which to compare the proposed protocol's anti-treaty shopping language. The anti-treaty shopping rule of the proposed protocol applies only to the following treaty benefits: business profits (Article 7), dividends (Article 10), interest (Article 11), royalties (Article 12), capital gains (Article 13), and other income (Article 22). The model anti-treaty shopping article applies to all benefits under the model treaty, not just to specified benefits. The largest omission appears to be the omission of coverage of shipping and aircraft income. The staff is not aware of current tax plans wherein third country residents use Italy as a base for shipping operations, however. Moreover, most foreign shipping income

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[2] *Tax Convention and Proposed Protocols with Canada*, Report of the Senate Committee on Foreign Relations. Exec. Rpt. No. 98-22. May 21, 1984, pp.7-8.

[3] *Id.*

is already exempt from U.S. tax under reciprocal exemptions contemplated by the Code (sec. 883).

The model contains a 75-percent ownership test, in contrast to the 50-percent ownership test of the proposed protocol and some recent treaties. In addition, the model contains a "base erosion" rule that denies treaty benefits to a person when a substantial part of that person's gross income is used (directly or indirectly) to meet liabilities (including liabilities for interest or royalties) to third country residents. The proposed treaty omits this rule. This base erosion rule prevents use of a company whose owners met the ownership test to pay treaty-protected interest or royalties (or other amounts) to third-country residents.

While an argument might be made that a broader anti-treaty shopping provision is appropriate, Italy is a relatively high tax country with no known history as a tax haven for conduit entities established by third country investors. At present, it is doubtful that third country investors would seek to use Italy as a base for treaty shopping. One concern, however, is that abuses could develop in the future. It has proved difficult to renegotiate treaties once abuses develop. Another concern is that this provision creates a precedent that may weaken the Treasury Department's ability to negotiate comprehensive anti-treaty shopping provisions in future treaties.

(6) Withholding rate on royalties

The existing treaty generally provides a zero withholding tax rate for royalty payments. For example, Italy generally cannot now tax a royalty payment to a U.S. person for the use of intangibles in Italy. The proposed treaty would allow each country to tax royalty payments made to residents of the other country, albeit at a rate that can never exceed 10 percent or some lesser limit. The U.S. model treaty prohibits source country taxation of royalties. In general, more recent treaties conform more closely to the U.S. model than the older treaties they replace. The issue is whether it is appropriate to agree to source country taxation of royalties when the current treaty prohibits such taxation. The existing treaty does not prohibit *local* Italian taxes on royalties, while the proposed treaty limits the combined Italian taxes (local and national) to no more than 10 percent.

(7) Branch-level tax

The United States does not now impose a branch-level tax, but the Administration's May 1985 tax reform proposal asks Congress to enact one. The proposed treaty does not specifically refer to a branch-level tax. Many argue, however, that the nondiscrimination rule protecting permanent establishments that is found in the proposed treaty and in most U.S. income tax treaties forbids the imposition of a branch-level type tax on permanent establishments. The Administration has responded to this argument by asking Congress not to override treaties. On enactment, the Administration would seek to renegotiate treaties to allow the United States to impose the branch-level tax that Congress enacted as a general rule in particular countries where current treaties prohibit its imposition. The issue is whether the sequence of actions that the Administration

asks Congress in general and the Senate in particular to take makes sense. If the Senate agrees to a treaty with Italy, for example, and then Congress enacts a branch-level tax that the treaty protects Italian corporations from paying, it is unclear why Italy would agree to allow the United States to impose that tax. Italy could unilaterally concede the issue, but Italy could instead ask for a quid pro quo from the United States, or Italy could instead not yield on this point. Experience has shown that it is difficult to renegotiate treaties once ratified.

The Committee might address this issue in one of three ways. First, the Committee could follow the Administration's request and recommend that the Senate consent to the treaty notwithstanding on this branch-level tax issue. It is not clear if or when Congress will enact a branch-level tax; if Congress does not do so, then there will have been no need for the Committee to take notice of this issue. Similarly, if Congress overrides treaties in enacting a branch-level tax, there is no need for current adverse Commmittee action. Overriding the treaty soon after approval could disappoint Italy's legitimate expectations, however. Second, the Committee could seek a reservation allowing the United States to impose a branch-level tax if it decides to do so. This course, while it could allow the United States to collect the tax (if enacted), could also present a condition that the Italian Government finds unacceptable. Therefore, this course could delay or prevent the benefits of the treaty. Third, the Committee could delay action on the treaty while it awaits legislative progress on the Administration proposals for tax reform. While the proposed treaty will be effective retroactively to January 1, 1985, if it enters into force during 1985, this course would delay at least the time when taxpayers will know what rules will apply to transactions that are to occur and to some significant transactions that have already occurred.

(8) Dividends paid deduction and imputation credit

The Administration's tax reform proposal presents another issue. The Administration proposal would allow a 10-percent dividends paid deduction to U.S. corporations. The purpose of this deduction is to reduce the burden of the two-tiered taxation of corporate profits under the "classical" system of present law, which imposes a tax at the corporate and shareholder levels. The dividends paid deduction would extend to some dividends paid to foreign shareholders. Absent treaty protection, however, the proposal would impose on such dividends a compensatory withholding tax designed to prevent elimination of all tax on 10 percent of corporate profits where shareholders are not U.S. taxpayers. The proposed treaty with Italy would prohibit U.S. imposition of this compensatory withholding tax. So would the existing treaty with Italy. Although the Administration proposal would not initially impose a compensatory tax on dividends paid to protected treaty country recipients, including Italian recipients, it would delegate to the Secretary of the Treasury the authority to override treaties to impose a compensatory dividend withholding tax on a country-by-country basis. The purpose of this delegation is, in part, to seek equivalent relief from treaty partner countries.

Many countries which reduce the burden of the two-tier tax do so through a mechanism other than a dividends paid deduction. These countries, including Italy, give resident shareholders a tax credit when they receive dividends. Italy's partial tax credit for resident shareholders reflects taxes that the corporation paid on the profits it is distributing in the form of dividends. For the shareholder, the credit is basically the economic equivalent of a partial dividends paid deduction. Italy gives individual Italian residential shareholders a credit for one-third of corporate taxes paid, while it gives corporate Italian resident shareholders a credit for three-sevenths of corporate taxes paid. However, Italy, like other countries, does not give this credit to foreign shareholders unilaterally. Some countries have given part of this credit to U.S. shareholders by treaty, but neither the existing treaty with Italy nor the proposed treaty does so. Under the Administration tax reform proposal, the Secretary of the Treasury could impose the compensatory withholding tax if the home country of the recipient (such as Italy) continued to deny relief to dividends paid by local companies to American shareholders.

Here, again, the Committee and the Senate have three choices. One possibility is consenting to the treaty as proposed. Congress might not enact any dividend relief, or it might enact a credit mechanism for dividend relief like Italy uses. In either of those events, there would be no treaty violation by the United States. (Even though the credit method and the deduction method proposed by the Administration achieve the same economic result (at least if the credit is refundable), the credit method does not violate treaties while the deduction method does.) However, consent to the treaty as proposed might lead to disappointment by Italy (if the United States later overrides the treaty and imposes a compensatory tax on dividends paid to Italian shareholders) or partial failure of the Administration proposal to take effect (if the United States fails to impose the compensatory tax on dividends paid to Italian shareholders out of a concern for the Italian Government based on a recently negotiated treaty.) Second, the Committee could seek a reservation allowing the United States to impose a compensatory withholding tax if it decides to do so. This course could present a condition that the Italian Government finds unacceptable, so that it could delay or prevent the proposed treaty's taking effect. Third, the Committee could await legislative progress on the Administration proposals for tax reform to decide how to handle this issue. This course too, could delay the treaty, however.

A related issue is the denial to U.S. shareholders in Italian corporations of imputation credits that Italian shareholders in Italian corporations get. The U.S. income tax treaties with the United Kingdom and France, which, like Italy, have imputation systems, provide U.S. portfolio investors with a credit equal to the credit a U.K. or French resident would have received. On the other hand, the U.S. income tax treaty with Canada, which also has an imputation system, does not allow U.S. shareholders in Canadian companies any portion of the imputation credit provided by Canadian statute to Canadian shareholders in Canadian companies. Under present U.S. income tax treaties, however, no imputation system country except the United Kingdom allows U.S. direct investors

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any portion of the imputation credit provided its own residents. The U.S. treaty with the United Kingdom provides U.S. direct investors (defined more broadly than in the proposed treaty) with a credit equal to one-half of the credit which an individual U.K. resident would be entitled to were he the recipient of the dividend.

(9) Timing considerations

Taxpayers assert several reasons for quick Senate action on the proposed treaty. If the proposed treaty goes into effect during 1985, taxpayers will be able to choose between the existing treaty and the proposed treaty for transactions occurring in 1985. The proposed treaty contains a number of rules that are more favorable to U.S. taxpayers than those contained in the existing treaty. In particular, it prohibits source country taxation of capital gains (except real property gains). Staff understands that at least one U.S. taxpayer has sold Italian property at a substantial gain in 1985, and that Italy will forgive the tax on that gain only if the proposed treaty takes effect in 1985. While this taxpayer and others might benefit from early action, nothing compels Italy to take steps to make the treaty effective in 1985 even if the Senate agreed to the treaty immediately. However, staff understands that the Italian Government is proceeding with its ratification procedures at this time. In addition, the potential benefit of quick action to this taxpayer (and similarly situated taxpayers) must be weighed against factors that might militate for delay. These factors include those discussed above in connection with the Administration proposal for tax reform, and the possible need for reservations to make the proposed treaty reflect sound U.S. tax policy. It is not totally clear that any one or some combination of the reservations that the Committee might consider would necessarily delay the treaty's entry into force beyond 1985, however.

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected.

U.S. source fixed or determinable annual or periodical income of a nonresident alien or foreign corporation (including generally interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. This tax is often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. The 30-percent (or lower treaty rate) tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence these taxes are often called withholding taxes).

Certain exemptions from the 30-percent tax are provided. Bank account interest is defined as foreign source interest and, therefore, is exempt. Exemptions are provided for certain original issue discount and for income of a foreign government from investments in U.S. securities. Under the Tax Reform Act of 1984, certain interest paid on portfolio obligations issued after July 18, 1984 (the 1984 Act's date of enactment) is exempt from the 30-percent tax. U.S. treaties also provide for exemption from tax in certain cases.

U.S. source noneffectively connected capital gains of nonresident individuals and foreign corporations are generally exempt from

U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate.

The source of income received by nonresident aliens and foreign corporations is determined under rules contained in the Internal Revenue Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are generally considered U.S. source income. However, if a U.S. corporation derives more than 80 percent of its gross income from foreign sources, then dividends and interest paid by that corporation will be foreign source rather than U.S. source. Conversely, dividends and interest paid by a foreign corporation, at least 50 percent of the income of which is effectively connected income, are U.S. source to the extent of the ratio of its effectively connected income to total income.

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the county in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

Prior to the Tax Reform Act of 1984, a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that corporation on earnings that are received as dividends. These deemed paid taxes are included in total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Separate foreign tax credit limitations are provided for DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and certain interest, respectively. Also, a special limitation applies to the credit for taxes imposed on oil and gas extraction income. The Code sometimes disregards intermediate entities to apply these limitations correctly.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each

of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent tax and seeks to reduce this tax (on some income to zero) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause". Double taxation can also still arise because most countries will not exempt passive income from tax at the source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income will be exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law.

The objective of preventing tax avoidance and evasion is generally accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further assured under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individ-

ual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries without income tax treaties with the United States attempt to use a treaty to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

The treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against its enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Italy (as modified by the proposed protocol) appears below. The proposed protocol is unusual in that its signing occurred at the same time as the signing of the proposed treaty. Some of the provisions of the proposed protocol (those in Article 1 of the proposed protocol) amend specific articles of the proposed treaty, while others do not. This explanation first discusses the articles of the proposed treaty (as amended by the proposed protocol); the explanation then discusses provisions of the proposed protocol that do not refer to particular articles of the proposed treaty. The proposed treaty and the proposed protocol, upon entry into force, would operate as one document, and it is of no consequence that some provisions appear in the proposed protocol while others appear in the body of the proposed treaty.

Article 1. Personal Scope

The personal scope article describes the persons who may claim the benefits of the proposed treaty and contains other rules including the "saving clause" that generally allows each country to tax its citizens and residents notwithstanding the proposed treaty.

The proposed treaty applies generally to residents of the United States and to residents of Italy, with specific exceptions designated in other articles. This follows other U.S. income tax treaties, the U.S. model income tax treaty, and the OECD model income tax treaty. Residence is defined in Article 4.

Like all U.S. income tax treaties, the proposed treaty also contains a "saving clause." Under this clause, with specific exceptions described below, the treaty is not to restrict the taxation by either country of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Italy as if the treaty were not in force. "Residents" for purposes of the treaty (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals (Article 4 (Resident)).

Under Section 877 of the Internal Revenue Code of 1954, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, will, with respect to certain income, be subject to tax for a period of 10 years following the loss of citizenship. The treaty (as amended by paragraph 1 of Article 1 of the protocol) contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax former citizens. Even absent a specific provision the Internal Revenue Service takes the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).

The treaty provides exceptions to the saving clause for certain benefits conferred by the articles dealing with alimony and child support (Article 18 (Pensions)); relief from double taxation (Article 23); non-discrimination (Article 24); and mutual agreement procedure (Article 25). Most of these exceptions are standard. However, the saving clause does not normally apply to alimony, so the United States ordinarily retains the right to tax alimony that U.S. citizens receive wherever they reside. The proposed treaty, by contrast, would prevent U.S. taxation of alimony received by U.S. citizens who are Italian residents.

In addition, the saving clause does not apply to the benefits conferred by one of the countries under the articles dealing with government service (Article 19), professors and teachers (Article 20), students and trainees (Article 21), and diplomatic agents and consular officers (Article 28), to individuals who are not citizens of the conferring country and do not have "immigrant status" in the conferring country. This exclusion is standard, except that most recent U.S. treaties and the U.S. model do not contain special rules for professors or teachers. For U.S. purposes, an individual has immigrant status in the United States if he has been admitted to the United States as a permanent resident under U.S. immigration laws (*i.e.*, holds a "green card").

Normally, the United States retains the sole right to tax U.S. social security payments. The proposed treaty grants primary taxing jurisdiction over such payments to the residence county, however. Although the saving clause generally allows residual taxing jurisdiction to the country paying the benefit, the proposed treaty bars the payor country from taxing its social security payments to its nationals who are nationals and residents of the other country (Article 1, paragraph 2 of the protocol). Therefore, the United States would waive its right to tax U.S. social security payments it makes to Italian residents who have dual U.S.-Italian nationality.

In the case of Italian taxes, there is a further restriction of the saving clause. Italy agrees to forego full residence-based taxation in the case of a U.S. citizen who is an Italian resident and a partner of a U.S. partnership. Italy agrees to allow a refundable credit against that individual's personal income tax equal to the corporation income tax that Italy imposed on the U.S. partnership for the same period (Article 1, paragraph 2 of the protocol).

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and Italy.

In the case of the United States, the proposed treaty applies to (1) the Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes, (2) the excise tax on private foundations, and (3) the insurance excise tax. Under the Internal Revenue Code, premiums from insuring U.S. risks which are received by a foreign insurer having no U.S. trade or business are not subject to U.S. income tax but are subject to the U.S. insurance excise tax (Code secs. 4371-4374). This insurance excise tax is covered by the proposed treaty only to the extent that the foreign in-

surer does not reinsure the risks in question with a person not entitled to relief from this tax under the proposed treaty or another U.S. treaty (Article 1, paragraph 3 of the protocol). Therefore, under the business profits article (Article 7) and other income article (Article 22), income of an Italian insurer from the insurance of U.S. risks will not be subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to the exemption) if that insurance income is not attributable to a U.S. permanent establishment maintained by the Italian insurer. The existing tax treaty with Italy does not cover this tax, but some other recent U.S. tax treaties, for example, the treaties with France and Hungary, do cover it. The excise tax on premiums paid to foreign insurers is a covered tax under the U.S. model tax treaty.

The insurance excise tax will continue to apply notwithstanding the proposed treaty in situations where an Italian insurer with a U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign insurer other than a resident of Italy or another insurer entitled to exemption under a different tax treaty (such as the U.S.-French treaty). For example, an Italian company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with a German insurance company (not currently entitled to exemption from the excise tax) and pays that German company a premium of $100. The four-percent excise tax on casualty insurance applies to the premium paid to the Italian insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured is liable for an excise tax of $4, which is four percent of the portion of its premium to the Italian insurer which was used by the Italian insurer to reinsure the risk. It is the responsibility of the U.S. insured to determine to what, if any, extent the risk is to be reinsured with a nonexempt person.

In the case of Italy, the proposed treaty applies to the individual income tax (l'imposta sul reddito delle persone fisiche), the corporation income tax (l'imposta sul reddito delle persone giuridiche), and the local income tax (l'imposta locale sui redditi) except to the extent that the local income tax applies to cadastral income (imputed income from the rental value of real property), whether or not Italy collects by withholding at the source. If the treaty applied to the tax on cadastral income, the United States would have to credit that tax. It would be inappropriate to credit that tax to the extent that Italy imposes that tax on the basis of real property value rather than net income.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes that either country may subsequently impose. The proposed treaty, like the U.S. model, obligates the competent authority of each country to notify the competent authority of the other country of any substantial changes in the tax laws of his country.

Article 3. General Definitions

The proposed treaty contains certain of the standard definitions found in most U.S. income tax treaties.

The term "person" is defined to include an individual, an estate or trust, a company and any other body of persons. A "company" is any body corporate or any entity which is treated as a company or body corporate for tax purposes.

An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise" it would have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, partnership, company, or other entity.

The proposed treaty defines international traffic as any transport by a ship or aircraft by an enterprise of one of the two countries, except where the transport is solely between places in the other country. Accordingly, with respect to an Italian enterprise, purely domestic transport in the United States is excluded.

The U.S. competent authority is the Secretary of Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of the Internal Revenue Service, who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchanges of information. The Director, Foreign Operations District (formerly called the Director of the Office of International Operations), has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection. The Italian competent authority is the Ministry of Finance.

The "United States" means the United States of America, a term that does not include Puerto Rico, the Virgin Islands, Guam or any other United States possession or territory. The definition of the United States also includes, when the term is used in a geographical sense, the territorial waters of the United States and any area beyond the territorial waters that, in accordance with international law and the laws of the United States, is (or may at a later time be) designated as an area within which the United States may exercise rights with respect to the sea-bed and sub-soil and natural resources. The intent of this rule is to cover the U.S. continental shelf in conformity with the definition of continental shelf contained in section 638 of the Code.

The term "Italy" means the Republic of Italy; it also includes the territorial waters of Italy and any area beyond the territorial waters which by Italian legislation and in accordance with customary international law has been, or may at a later time be, designated as an area in which Italy may exercise rights with respect to the sea-bed and sub-soil and natural resources. Therefore, income earned on the Italian continental shelf is covered.

The proposed treaty defines the term "nationals" to mean individual citizens and legal persons, partnerships, and associations deriving their status from the law in force in the United States or Italy. Under this definition, for example, a corporation organized under the law of one of the United States is a U.S. national. One result of this broad definition is a broad application of the non-discrimination rules (Article 24).

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities

of the two countries establish a common meaning, all terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty.

Article 4. Resident

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where under the laws of the countries the person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on U.S. source income and on his income that is effectively connected with a U.S. trade or business. A company is a resident of the United States if it is organized in the United States. Prior to the Tax Reform Act of 1984, the Code did not provide standards for determining whether an alien individual was a resident. Under U.S. Treasury regulations, an alien was a resident of the United States if he was actually present in the United States and was not a mere transient or sojourner. Whether he was a transient was determined by his intentions as to the length and nature of his stay. (See Treas. Reg. sec. 1.871-2(b).) Under the standards for determining residence provided in the 1984 Act (which were generally effective on January 1, 1985), an individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident. A permanent resident for immigration purposes also is a U.S. resident. The standards for determining residence provided in the 1984 Act do not apply in determining the residence of a *U.S. citizen* for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States).

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that State, is subject to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. However, the term "resident of a Contracting State" does not include any person who is subject to tax in that country in respect only of income from sources in that country.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. model and OECD model tax treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas (in countries other than Italy) are not entitled to the benefits of the treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the U.S. model. The U.S. position is achieved in very few treaties.

Moreover, in the case of income derived or paid by a partnership, an estate, or trust, the term "resident of a Contracting State" applies only to the extent that the income derived by the partnership, estate, or trust is subject to tax in that country as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. For example, if the share of U.S. residents in the profits

of a U.S. partnership is only one-half, Italy would have to reduce its withholding tax on only half of the Italian source income paid to the partnership.

The proposed treaty provides a set of "tie-breaker" rules to determine residence in the case of an individual who, under the basic treaty definition, would be considered to be a resident of both countries. Such a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, *i.e.*, his "center of vital interests". If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he shall be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a national (citizen). If he is a national of both countries or of neither of them, the competent authorities of the countries are to endeavor to settle the question of residence by mutual agreement.

In the case of a person other than an individual or a company who is resident of both countries under the basic treaty definition, the proposed treaty requires the competent authorities of the two countries to endeavor to settle the question by mutual agreement and to determine how the treaty applies to that person.

There is no tie-breaker rule for companies. Companies that are residents of both countries would generally be fully taxable by both under the saving clause (Article 1).

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" which, with certain exceptions, follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the reduced rates of, or certain exemptions from, tax provided for dividends, interest, and royalties will apply unless the asset generating the income is effectively connected with the permanent establishment, in which case such items of income are taxed as business profits. U.S. taxation of business profits is discussed under Article 7 (Business Profits).

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, a quarry, or other place of extraction of natural resources. It also includes any building site or construction or assembly project, if the site or project lasts for more than 12 months.

This 12-month period corresponds to the rule of the U.S. model treaty.

A drilling rig or ship used for the exploration or development of natural resources situated in a country gives rise to a permanent establishment only if it remains in that country for more than 180 days in any 12 month period (Article 1, paragraph 4 of the proposed protocol). This 180-day rule differs from the 12-month rule of the U.S. model treaty. The current treaty does not contain special rules for building sites, exploration and exploitation of natural resources, etc.

The general rule is modified to provide that a fixed place of business that is used solely for specified activities will not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise or for the maintenance of a stock of goods belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information, or solely for the purpose of carrying on, for the enterprise, advertising, the supply of information, scientific research, or other similar activities that have a preparatory or auxiliary character.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, then the enterprise will generally be deemed to have a permanent establishment in the first country. This rule does not apply where the person's activities are limited to the purchase of goods or merchandise for the enterprise. The proposed treaty contains the usual provision that the agency rule will not apply to create a permanent establishment if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. The relationship is thus not relevant; only the activities of the company being tested are relevant.

Article 6. Income from Immovable Property

This article covers income from owning immovable (real) property. The rules governing income from the sale of real property are in Article 13.

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the real property is located. Income from real property includes income from agriculture or forestry.

The term "real property" has the meaning which it has under the law of the country in which the property in question is situated. The term in any case includes property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or

fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Thus, income from real property will include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). Ships, boats and aircraft are not real property.

The source country may tax income derived from the direct use, letting, or use in any other form of real property. These rules allowing source country taxation also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Certain U.S. treaties and the current U.S. model treaty permit residents of one country to elect to be taxed on income from real property in the other country on a net basis. The existing treaty allows taxpayers to elect net basis taxation of income from real property on a year-by-year basis. The proposed treaty does not contain an election, but such an election is provided for U.S. real property income under the Code (secs. 871(d) and 882(d)), and Italy taxes income from real property on a net basis. Also, certain treaties limit the tax a country may impose on rental or royalty income from real property. There is no limit in the proposed treaty.

Under Article 13 (Alienation of Property), gains on the sale, exchange or other disposition of real property (and shares of certain corporations owning real property) may also be taxed by the country where the property is located.

Article 7. Business Profits

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30 percent (or lower treaty rate) rate of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock

or debt derived in the active conduct of a banking, financing or similar business in the United States; and certain sales income attributable to a United States sales office.

Except in the case of a dealer, trading in stocks, securities or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S. based employee, a resident broker, commission agent, custodian or other agent or trading by a foreign person physically present in the United States.

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in trade or business before a country can tax business profits and by substituting the "attributable to" standard for the Code's "effectively connected" standard. Under the Internal Revenue Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits which might be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the enterprise of which it is a permanent establishment, or with any other associated enterprise. For example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for expenses, wherever incurred, which are attributable to the activities of the permanent establishment. These deductions specifically include executive and general administrative expenses. Thus, for example, a U.S. company which has a branch office in Italy but which has its head office in the United States will, in computing the Italian tax liability of the branch, be entitled to deduct the executive, general administrative and other expenses incurred in the United States by the head office that are reasonably connected with the profits of the Italian branch.

Unlike some U.S. treaties and the U.S. model, the proposed treaty does not define the term "business profits." Thus, to the

extent not dealt with in other Articles, the term will be defined under the laws of the two countries. If the definitions cause double taxation, the competent authorities could agree on a common meaning of the term. The proposed treaty may thus leave it to Italian law, for example, to determine whether an item of income not dealt with elsewhere in the treaty that is earned by a U.S. company through a permanent establishment in Italy constitutes business profits and, therefore, is taxable by Italy under this treaty article.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities.

The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not this Business Profits Article, will govern the treatment of those items of income. Thus, for example, film rentals are taxed under the provisions of Article 12 (Royalties), and not as business profits.

Article 8. Shipping and Air Transport

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the ship or aircraft is documented under the laws of a foreign country that grants an equivalent exemption to U.S. citizens and corporations operating ships or aircraft documented under U.S. law. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

The proposed treaty provides that profits which are derived by an enterprise of one country from the operation of ships or aircraft in international traffic ("shipping profits") shall be exempt from tax by the other country. International traffic means any transportation by ship or aircraft, except where the transportation is solely between places in the other country (Article 3(1)(d) (General Definitions)). This exemption applies even if the ship or aircraft is not registered in either country. Thus, for example, income of a U.S. resident from the operation of a ship flying, for example, the Liberian flag would not be subject to Italian tax. The exemption also applies to income derived from the operation of ships and aircraft in international traffic through participation in a pool, a joint business, or an international operating agency.

Under the proposed treaty, certain profits from the rental of ships or aircraft would be exempt from tax in the source country as profits from the operation of ships and aircraft in international traffic (Article 1, paragraph 5 of the proposed protocol). For instance, profits of an enterprise of one of the countries from the use, maintenance, or rental of containers (including trailers, barges,

and related equipment for the transport of containers) used for the transport in international traffic of goods or merchandise would be taxable only in the residence country. Profits from the rental on a full basis of ships or aircraft would be taxable only in the residence country. Profits from the rental on a bareboat basis of ships or aircraft would be taxable only in the residence country if such bareboat rental profits are incidental to other profits from the operation of ships or aircraft in international traffic.

This rule governing bareboat leases of ships or aircraft provides a narrower exemption for lessors than that provided in the U.S. model treaty, which provides the exemption either if the rented property is used in international traffic or if the profits are incidental to profits from the operation of ships or aircraft in international traffic. For example, the model provides exemption in the source country for a bareboat lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic but that leases ships or aircraft for use in international traffic. The proposed treaty would allow the source country to tax this bareboat rental income under the provisions of Article 12 (Royalties).

In addition, profits that a U.S. national that is not an Italian resident or that any U.S. corporation derives from operating U.S. flag ships or aircraft will be exempt from Italian tax (Article 1, paragraph 6 of the proposed protocol).

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to section 482 of the Internal Revenue Code which recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises.

For purposes of the proposed treaty an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control or capital of the other enterprise. The enterprises are also related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

When a redetermination of tax liability has been made by one country, the other country will (if it agrees with the redetermination) make an appropriate adjustment to the amount of tax paid in that country on the redetermined income (Article 1, paragraph 7 of the proposed protocol). This adjustment is to occur in accordance with the treaty's Mutual Agreement Procedure article (Article 25), and prior to the adjusting country's final tax determination for the year at issue.

To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship will not apply in the case of such adjustments.

These provisions of the proposed treaty do not affect the application of any law in either country that relates to the determination of the tax liability of a person. This provision makes clear that the U.S. retains the right to apply its intercompany pricing rules (sec-

tion 482) and its rules relating to the allocation of deductions (sections 861, 862, and 863, and Treas. Reg. Section 1.861-8) (Article 1, paragraph 8 of the proposed protocol).

Article 10. Dividends

The United States imposes a 30-percent tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates on a net basis.

U.S. source dividends for purposes of the 30-percent tax are dividends paid by a U.S. corporation (other than an "80/20 company" described in Code sec. 861(a)(2)(A)). Also treated as U.S. source dividends for this purpose are certain dividends paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that foreign corporation.

Under the proposed treaty, dividends paid by a company that is a resident of one country to a resident of the other country may be taxed by both countries. The proposed treaty limits, however, the rate of tax that the country of which the payor is a resident may impose on dividends paid to a beneficial owner in the other country. (None of the limitations on taxation of dividends would apply to taxation of the company in respect of the profits out of which the dividends are paid.) The limitation may be 15 percent, 10 percent, or 5 percent, and it depends on the relationship between the payor and the payee. The rate of source country tax can never exceed 15 percent of the gross amount of the dividends. If the paying company derives not more than 25 percent of its gross income from interest and dividends (other than interest and dividends from subsidiary companies or interest earned in a banking or financing business), then one of two lower rates may apply. (Article 1, paragraph 9 of the proposed protocol defines the term "subsidiary company" to mean a corporation in which the company paying the dividends owns more than 50 percent of the voting stock.) If the beneficial owner of the dividends has owned more than half of the voting stock of the paying company for the 12-month period ending on the dividend declaration date, the source country tax rate cannot exceed 5 percent. If the beneficial owner of the dividends does not qualify for the 5 percent rate but has owned 10 percent or more of the voting stock of the paying company for the 12-month period ending on the dividend declaration date, the source country tax rate cannot exceed 10 percent.

The existing treaty with Italy generally limits the source country tax on dividends paid to residents of the other country to 15 percent in the case of portfolio dividends and 5 percent in the case of direct dividends.

The proposed treaty defines dividends to mean income from shares, "jouissance" shares or "jouissance" rights, mining shares, founder's shares, or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which

is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident. Under Italian law, "jouissance" shares or rights carry no voting rights. They participate in profits after payment of dividends or liquidating distributions to other shareholders. This definition of dividend allows the United States to apply its domestic rules for determining whether an interest is debt or equity.

The proposed treaty provides that the competent authorities are to endeavor to settle the mode of application of this limitation. That is, as under U.S. law, the competent authority is to provide for implementation of the rule (as by requiring certification of the identity of foreign recipients of income).

The reduced rates of tax on dividends will apply unless the recipient carries on business through a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the dividends are attributable to the permanent establishment (or fixed base). Dividends effectively connected with a permanent establishment are to be taxed on a net basis as business profits (Article 7). Dividends effectively connected with a fixed base are to be taxed on a net basis as income from the performance of independent personal services (Article 14).

One country may tax dividends paid by a company resident only in the other country that derives income in the first country only in two cases: first, where a resident of the first country receives the dividends; and second, where the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base in the taxing country. The proposed treaty deviates from the U.S. model in not allowing source country taxation where at least 50 percent of the paying company's gross income was attributable to one or more permanent establishments in the taxing country. The model treaty provision would enable the United States to continue to tax dividends paid by foreign corporations doing substantial business in the United States. The model, however, also allows the treaty partner of the United States to impose an analogous tax on profits earned in the United States. Many countries impose such a tax, frequently in the form of a branch profits tax. Italy imposes no such tax, however.

The treaty prevents a country from imposing an undistributed profits tax on a nonresident company, even if its undistributed profits consist wholly or partly of income arising there.

Article 11. Interest

In general, the United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. However, the Tax Reform Act of 1984 repealed the tax for interest paid on certain portfolio indebtedness to nonresident alien individuals and foreign corporations. (This change was effective for interest paid on portfolio indebtedness issued after July 18, 1984, the date of enactment of the 1984 Act.) U.S. source interest, for this purpose, generally is interest on debt obligations of U.S. persons, but not interest on deposits in banks. U.S. source interest for this purpose also includes interest paid by a foreign corporation if at least 50 percent of the gross income of the foreign

corporation, in the prior three-year period, was effectively connected with a U.S. trade or business of that corporation. The tax imposed on the latter interest is often referred to as the "second tier" withholding tax.

Under the proposed treaty, interest may be taxed by a country if the beneficial owner of the interest is a resident of that country, the interest arose in that country, or the indebtedness to which the interest relates is effectively connected with a permanent establishment or fixed base in that country. The proposed treaty limits the withholding tax imposed at source on interest paid to a beneficial owner who is a resident of the other country to 15 percent generally. The present treaty does not limit the withholding tax on interest. The current Italian statutory withholding tax on interest applies at rates that depend on the type of debt. The rate is generally 15 percent, but interbank interest is exempt; interest on convertible bonds and bonds issued by banks is subject to a 10-percent rate; interest on other bonds and bank deposits is subject to a 20-percent rate. The U.S. model treaty provides for elimination of the withholding tax on portfolio interest (a zero rate), although this result is rarely achieved.

The lower rate in the proposed treaty applies only if the interest is beneficially owned by a resident of the other country. Accordingly, it does not apply if the recipient is a nominee for a nonresident. Article 2 of the proposed protocol provides additional rules designed to prevent treaty shopping.

The reduced tax rate will not apply if the recipient carries on business through a permanent establishment or fixed base in the source country and the debt claim is effectively connected with that permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty defines interest to mean income from Government securities, bonds, or debentures, whether or not secured, and whether or not carrying a right to participate in profits, debt-claims of every kind, and all income treated as interest by the tax law of the source country. Thus, the United States could apply its domestic rules for determining whether an interest is debt or equity.

Interest would be exempt from tax by the source country under the proposed treaty if the interest is derived and beneficially owned by the other country or any instrumentality of that other country or is derived and beneficially owned by a resident of the other country with respect to debt obligations guaranteed or insured by that country or an instrumentality of that country (such as the Export-Import Bank).

The proposed treaty provides a source rule for interest (which is also used in Article 23 (Relief from Double Taxation) for foreign tax credit purposes). Interest will be sourced within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country. However, if the interest is borne by a permanent establishment (or fixed base) that the payor has in Italy or the United States and the indebtedness was incurred with respect to that permanent establishment (or fixed base), interest will have its source in that coun-

try, regardless of the residence of the payor. Generally, this is consistent with U.S. source rules (sections 861-862) which provide that interest income is sourced in the country in which the payor is resident. Thus, for example, if a Swiss resident has a permanent establishment in Italy and that Swiss resident incurs indebtedness to a U.S. person for that Italian permanent establishment, and the permanent establishment bears the interest, then the interest will have its source in Italy.

The proposed treaty addresses the issue of non-arm's-length interest charges between parties having a direct or indirect special relationship by providing that the amount of interest for purposes of the treaty will be the amount of arm's-length interest. The amount of interest in excess of the arm's-length interest will be taxable according to the laws of each country, taking into account the other provisions of this treaty (e.g., excess interest paid to a shareholder may be treated as a dividend under local law and thus entitled to the benefits of Article 10 of this treaty).

Article 12. Royalties

Under the same system that applies to dividends and some interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles in the United States. Such royalties include motion picture royalties.

The U.S. model treaty exempts royalties from tax at source. The present treaty with does not generally allow source country taxation of royalties. The proposed treaty, however, allows limited source basis taxation of royalties. Royalties from sources (under the royalty source rule discussed below) in one country that are beneficially owned by a resident of the other country may be taxed by both countries. The limitation may be 5 percent, 7 percent, 8 percent, or 10 percent, and it depends on the type of property whose use the royalty allows. If a payment of any kind is received as a consideration for the use of (or the right to use) any copyright of literary, artistic, or scientific work, the source country tax rate cannot exceed 5 percent of the gross amount of the royalties. If royalties are received as a consideration for the use of (or the right to use) tangible personal (movable) property, the source country tax rate cannot exceed 7 percent of the gross amount of the royalties (Article 1, paragraph 10 of the proposed protocol). If a payment of any kind is received as a consideration for the use of (or the right to use) motion pictures and films, tapes, or other means of reproduction used for radio or television broadcasting, the source country tax rate cannot exceed 8 percent of the gross amount of the royalties. In all other cases of royalty payments, the source country tax rate cannot exceed 10 percent of the gross amount of the royalties. The rate limitations in the proposed treaty apply only if the royalty is beneficially owned by a resident of the other country; they do not apply if the recipient is a nominee for a nonresident.

Royalties are defined to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including motion pictures, films,

tapes or other means of reproduction used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

The reduced withholding tax rate does not apply where the beneficial owner carries on business through a permanent establishment in the source country or performs personal services in an independent capacity from a fixed base in the source country, and the royalties are attributable to the permanent establishment or fixed base. In that event the royalties will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

In limited cases, income from leasing of ships, aircraft, and containers would be royalties subject to withholding tax at the source of up to 10 percent of gross receipts if the lessor had no permanent establishment in the source country (see Article 8 (Shipping and Air Transport)).

The proposed treaty provides special source rules for royalties. Generally, under U.S. tax rules (section 861-862) royalty income is sourced where the property or right is being used. The treaty retains this rule, but applies other rules when this rule does not create a source in the United States or Italy. For example, if a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, or by a resident of one of the countries, then the income will generally be sourced in the country of residence of the payor if the place of use test does not produce a U.S. or Italian source. However, if the royalty does not pay for the use of property in either the United States or Italy but the payor has a permanent establishment or fixed base in the United States or Italy in connection with which the obligation to pay the royalty was incurred, and if the royalties are borne by the permanent establishment or fixed base, the royalties arise (for purposes of the proposed treaty) in the country in which the permanent establishment or fixed base is situated.

The proposed treaty provides that in the case of royalty payments or credits between persons having a special relationship, only that portion of the payment or credit that represents an arm's-length royalty will be treated as a royalty under the treaty. Payments in excess of the arm's-length amount will be taxable according to the law of each country with due regard being given for the other provisions of the treaty. Thus, for example, any excess amount might be treated as a dividend subject to the taxing limitations of Article 10.

Article 13. Capital Gains

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended, a nonresident alien or foreign cor-

poration is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations holding U.S. real property.

The current Italian treaty does not restrict source country taxation of capital gains. Under the proposed treaty, only certain capital gains are taxable in the source country. Gains from the disposition of real property may be taxed in the country where the real property is situated. The treaty defines real property situated in the United States and real property situated in Italy separately. Real property situated in the United States includes U.S. real property interests (Article 1, paragraph 11(a) of the proposed protocol). This definition will allow the United States to tax any transaction of an Italian resident taxable under the Foreign Investment in Real Property Tax Act of 1980.

Real property situated in Italy includes real property referred to in Article 6 (Immovable Property), shares or comparable interests in a company or other body of persons, the assets of which consist wholly or principally of real property situated in Italy, and an interest in the estate of a decedent, the assets of which consist wholly or principally of real property situated in Italy (Article 1, paragraph 11(b) of the proposed protocol). Such shares and interests are deemed to be situated in Italy, wherever the entity was created or is operated, and wherever any shares or other evidences of ownership may be found. The treaty does not define the term "principally."

Income or gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of a country has in the other country, or which are attributable to a fixed base available to a resident of a country in the other country for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, may be taxed in that other country.

Gains from the sale or exchange of ships, aircraft or containers operated or used by an enterprise of one country in international traffic are taxable only by the country of the enterprise's residence. The ships, aircraft, and containers whose disposition is exempt from source country capital gains tax under this provision corresponds to the property the profits from which are exempt from source country tax (Article 1, paragraph 12 of the proposed protocol).

Income or gains from the alienation of any property other than property discussed above would be taxable under the proposed treaty only in the country where the alienator is a resident.

Article 14. Independent Personal Services

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services

within the United States can be a trade or business within the United States (sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from income from the performance of personal services as an employee.

Income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed, unless (1) the person performing the personal services is present in the country where the services are performed for more than 183 days during any fiscal year, or (2) the individual has a fixed base regularly available to him in that country for the purpose of performing the services. In the second situation, the source country can tax only that portion of the individual's income which is attributable to the fixed base.

Independent personal services include, but are not limited to, scientific, literary, artistic, educational, and teaching activities, as well as independent services of physicians, lawyers, engineers, architects, dentists, and accountants.

The proposed treaty generally provides a broader exemption from tax than the present treaty. The present treaty exempts from source country tax income from personal services of an individual present there no more than 90 days during a taxable year if either the compensation for those services does not exceed $2,000 or the individual performs the services for a resident of the source country. However, the present treaty does not contain the fixed base rule of the proposed treaty; under the present treaty, a fixed base maintained in a country for the purpose of performing services does not necessarily cause taxation of those services in that country. The U.S. model treaty, by contrast, does not contain a 183-day rule, but rather allows taxation in the source country only on the basis of a fixed base regularly available to the individual performing the independent services.

Article 15. Dependent Personal Services

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days during a taxable year, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign permanent establishment of a U.S. person.

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will be taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during any fiscal year; (2) his or her employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country.

Compensation derived by an employee in respect of employment regularly exercised aboard a ship or aircraft operated in by an enterprise of one of the countries in international traffic may be taxed only by the country of that enterprise. Under the U.S. model treaty, by contrast, only the country where the employee resides (rather the the country of residence of the enterprise) may tax the income.

This article is modified in some respects for directors' fees (Article 16), pensions (Article 18), and compensation as a government employee (Article 19).

The present treaty does not distinguish between dependent and independent personal services. Those present treaty rules are discussed in the discussion of Article 14, above.

Article 16. Directors' Fees

The proposed treaty contains a special rule for directors' fees. If an individual who is a resident of one country serves as a member of the board of directors of company that is a resident of the other country, the country of the company's residence may tax him or her to the extent that the directors' fees and similar payments that he or she derives are attributable to services performed in the country of the company's residence (Article 1, paragraph 13 of the proposed protocol). There is no corresponding rule in the U.S. model treaty or in the existing treaty.

Article 17. Artistes and Athletes

The proposed treaty contains an additional set of rules which apply to the taxation of income earned by entertainers (such as theater, motion picture, radio or television "artistes" or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the article, one country may tax an entertainer or athlete who is a resident of the other country on the income from his personal services as an entertainer in that country during any year in which the gross receipts that he or she derives from such activities, including reimbursed expenses, exceed $12,000 or its equivalent in Italian lire. (The comparable amount in the U.S. model treaty is $20,000.) Thus, if an Italian entertainer maintained no fixed base in the United States and performed (as an independent contractor) for two days in one taxable year in the United States for total compensation of $10,000, the United States could not tax that income. If, however, that entertainer's total compensation were $14,000, the full $14,000 (less appropriate deductions) would be subject to U.S. tax. As in the case of the other provisions dealing with personal services income, this provision does not bar the country of residence from also taxing that income (subject to a foreign tax credit). In addition, regardless of the level of compensation, the source country may tax an entertainer or athlete who is a resident of the other country and who is present in the source country for more than 90 days in a fiscal year. There is no provision comparable to this 90 day rule in the U.S. model treaty.

In addition, the proposed treaty provides that where income in respect of personal services performed by an entertainer or athlete accrues not to the entertainer or athlete but rather to another person or entity, that income will be taxable by the country in which the services are performed in any situation where the entertainer or athlete shares directly or indirectly in the profits of the person or entity receiving the income. (This provision applies notwithstanding Articles 7, 14, and 15.) For this purpose, participation in the profits of the recipient of the income includes (without limitation) the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. The provision does not apply if it is established that neither the entertainer or athlete, nor related persons, participate directly or indirectly in the profits of the person or entity receiving the income in any manner. This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

Article 18. Pensions, Etc.

Under the proposed treaty, pensions and other similar remuneration beneficially derived by a resident of either country in consideration of past employment are subject to tax only in the recipient's country of residence. (A different rule applies in the case of pensions which are paid to citizens of one country attributable to services performed by the individual for government entities of the other (Article 19 (Governmental Service)). The saving clause allows each country to continue to tax its citizens who are residents of the other country on pensions and similar remuneration.

Payments under the Social Security legislation of one country and similar public pension payments made to a resident of the other country or to a U.S. citizen will be taxable only by the country of residence. This rule is generally subject to the saving clause. The saving clause generally permits the United States to tax U.S. social security and similar payments made to U.S. citizens who are Italian residents. Article 1, paragraph 2(a) of the proposed protocol overrides the saving clause and prohibits U.S. taxation of such payments to dual U.S.-Italian nationals who are Italian residents, however. The U.S. model treaty, by contrast, allows only source country taxation of social security and similar payments, and prevents residence country taxation by an exception to the saving clause.

The proposed treaty also provides (subject to the saving clause) that annuities may be taxed by only the country of residence of the person who beneficially derives them. Annuities are defined as stated sums paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (in money or money's worth). The requirement that the consideration for an annuity be in money or money's worth distinguishes annuities from pension payments, the consideration for which is services.

The proposed treaty provides that alimony and child support payments paid to a resident of one country by a resident of the other country would be taxable only in the country of the payor's

residence. Alimony and child support payments would not be taxable in either country if the payor cannot deduct those payments in the country of his residence. Thus, for example, child support payments from a U.S. resident to an Italian resident would not be taxable in either country. The saving clause would not apply to alimony or child support payments, so that the United States could not tax such payments made by Italian residents to U.S. citizens or residents, or such payments made to Italian residents by U.S. citizens who are not U.S. residents. Under the U.S. model treaty, by contrast, while child support payments are taxable only by the country of the payor, alimony payments (and other maintenance payments other than child support payments) are taxable only by the country of residence of the recipient. Like the child support rule in the proposed treaty, the child support rule in the U.S. model is not subject to the saving clause.

The proposed treaty defines alimony to mean periodic payments made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support that are taxable to the recipient under the laws of his or her country of residence. The proposed treaty defines child support to mean periodic payments made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support for the support of a minor child.

Article 19. Government Service

The proposed treaty contains the standard provision that generally exempts the wages of employees of one of the countries from tax by the other country.

Under the proposed treaty, remuneration, other than a pension, paid by a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) would generally be taxable only in that country. However, such remuneration would be taxable only in the country of performance (the country not the payor) if the individual is a resident of the country of performance who either (1) is a citizen of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, Italy would not tax the compensation of a U.S. citizen and resident (not an Italian citizen) who is in Italy to perform services for the U.S. government, and the United States would not tax the compensation of a Italian citizen and resident (not an U.S. citizen) who performs services for the Italian Government in the United States. However, a special rule applies to the spouse or dependent child of an individual who (1) is exempt from tax in one country on the ground that he or she performs services for the other country and (2) neither is a national of the other country nor established residence there to perform services. Such a spouse or child will not incur source country taxation on income from government services performed for the other country so long as he or she is not a national of the source country. For example, if a U.S. husband and wife move to Italy so that the wife may work for the U.S. government there, Italy would not tax the income of the husband if he later began working for the U.S. government in Italy during her employment.

Any pension paid by, or out of funds created by, a country or one of its political subdivisions or local authorities to an individual for services rendered to that country (or subdivision or authority) would generally be taxable only in that country. However, such pensions would be taxable only in the other country if the individual is both a resident and a citizen of that other country. The saving clause applies to retain residual citizenship-based taxation in the United States on public pension income paid by a U.S. payor in the case of a dual U.S.-Italian citizen who is a resident of Italy. The United States must credit Italian taxes on this income, however.

In the situations described above, the U.S. model treaty allows exclusive taxing jurisdiction to the paying country, but only in the case of payments to one of its citizens.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature) the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 16 (Directors' Fees), 17 (Artistes and Athletes) and 18 (Pensions, Etc.) would apply to remuneration and pensions for services rendered in connection with the business.

The saving clause does not apply to this provision insofar as it confers benefits on individuals who are not citizens of and who do not have immigrant status in the taxing country.

Article 20. Professors and Teachers

The proposed treaty provides in certain cases that a professor or teacher who makes a temporary visit to one country for the purpose of teaching or conducting research at an educational institution or at a medical facility primarily funded from governmental sources would be exempt from source country tax for up to two years on remuneration from such teaching or research. To qualify for the exemption, the visitor must be a resident of the other country or have been a resident of the other country immediately before the visit. In addition, there would be no source country exemption for research income undertaken for private benefit rather than in the general interest. The present treaty contains a similar rule for teachers as do some other U.S. income tax treaties. Under the U.S. model, teachers who perform dependent personal services are subject to the general rules for employees, which tend to allow greater source country jurisdiction.

Article 21. Students and Trainees

Under the proposed treaty, a student or business apprentice (trainee) who is a resident of one country and who is present solely for the purpose of his or her education or training in the other country will generally be exempt from tax in the host country on payments from abroad used for maintenance, education, or training. This rule also applies to a student who was a resident of one country immediately before visiting the other country. There is no precise limitation on the amount of income to which the exemption applies. The saving clause does not generally apply to this article. This exemption applies only if the payments arise outside the coun-

try where the student or trainee receives his or her education or training.

Article 22. Other Income

This article is a catch-all article intended to cover items of income not specifically covered in other articles, and to assign the right to tax third country income to only one of the countries. It applies to income from third countries as well as income from the United States and Italy.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country shall be taxable only by the country of residence. In general, the proposed treaty thus gives the United States the sole right to tax income arising in a third country and paid to a resident of the United States. However, if the right or property in respect of which the income is paid is effectively connected with a permanent establishment or fixed base in the treaty country that is not the residence country, that country may also tax it. In addition, income from real property that is not subject to another treaty provision is taxable only in the country of residence of the person earning the income, whether or not the real property is effectively connected with a permanent establishment or fixed base in the other treaty country. The effect of this provision is to allow the residence country to tax income from real property located in a third country, even if that real property should somehow be effectively connected with a permanent establishment or fixed base in the treaty country not of residence.

This provision is subject to the saving clause, so U.S. citizens who are Italian residents would continue to be subject to U.S. taxation on their worldwide income.

Article 23. Relief from Double Taxation

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on only foreign source income. This limitation is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for certain interest, oil and gas extraction income, FSC dividends, taxable income of a FSC attributable to foreign trade income, and DISC dividends.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are re-

ceived as dividends (deemed paid credit). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income. This article provides further relief where both Italy and the United States would still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that this article applies.

The present treaty generally provides for relief from double taxation by each country permitting a credit against its tax for the appropriate amount of taxes paid to the other country on income from sources within that other country. The credit is provided, however, only to the extent permitted under certain domestic laws, and the Italian credit for U.S. taxes on dividends under the current treaty does not exceed 8 percent of the amount of the dividend.

The proposed treaty provides separate rules for relief from double taxation for the United States and Italy. In addition, it provides special rules covering U.S. citizens resident in Italy.

United States

The proposed treaty contains a provision like that found in many U.S. income tax treaties that the United States will allow a U.S. citizen or resident a foreign tax credit for income taxes paid or accrued to Italy. The credit is to be computed in accordance with the provisions of and subject to the limitations of U.S. law (as those provisions and limitations may change from time to time without changing the general principles of the credit).

The proposed treaty also allows the U.S. deemed paid credit (sec. 902) to U.S. corporate shareholders of Italian corporations receiving dividends from those corporations if the U.S. company owns 10 percent or more of the voting stock of the Italian corporation. The credit is allowed for Italian income taxes paid by or on behalf of the Italian corporation on the profits out of which the dividends are paid. It would not be appropriate for this deemed paid credit to be available for dividends paid by a U.S. company that is a resident of Italy.

This article provides that Italian income taxes covered by the treaty (Article 2 (Taxes Covered)) are to be considered income taxes for purposes of the U.S. foreign tax credit. Accordingly, all such Italian taxes will be eligible for the U.S. foreign tax credit. These taxes would probably be creditable for U.S. tax purposes in the absence of the proposed treaty. Local taxes on cadastral income, which the treaty does not cover, are not creditable to the extent that they are property taxes.

Italy

The proposed treaty generally provides that in taxing its residents Italy may include in its tax base income that the United States may tax under the proposed treaty, but that if Italy does so, it must credit U.S. taxes paid by Italian residents on that income that is taxable in the United States. This credit is not to exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen. That is, in the case of a Italian resident who is subject to U.S. tax on worldwide income as a U.S. citizen, Italy will credit only the U.S. tax to which the Italian resident would have been subject absent U.S. citizenship. In addition, the credit cannot exceed the proportion of the resident's Italian income tax that U.S. source income bears to worldwide income. In effect, Italy would limit its foreign tax credit on a per-country basis with respect to the United States under the proposed treaty.

Current Italian law provides that Italian residents can elect to bear a gross withholding tax rather than a net income tax on certain investment income. This election governing Italian tax liability can apply even to certain U.S. source income. Under the proposed treaty, Italy need not credit U.S. taxes if the item of income is subjected in Italy to a final withholding tax by request of the recipient in accordance with Italian law.

Source rules

This article provides that U.S. income taxes covered by the treaty (Article 2 (Taxes Covered)) are to be considered income taxes for purposes of the Italian foreign tax credit. Accordingly, all such U.S. taxes will be eligible for the Italian foreign tax credit.

The proposed treaty does not obligate Italy to grant a foreign tax credit for U.S. taxes if Italy does not include income that is taxable in the United States in its income tax base. That is, the proposed treaty allows Italy to choose between a foreign tax credit method and an exemption method for mitigating double taxation of its residents.

In this article, the proposed treaty also provides source rules for determining when an item of income arises in one of the countries. These source rules are used for the purpose of allowing relief from double taxation under this Article. Under normal U.S. concepts, these source rules will not supersede the U.S. source of income rules for the purpose of internal U.S. law.

The general source rule is that an item of income of a resident of one country (that is not a resident of the other country) that may be taxed in the other country under the treaty is considered to arise in that other country. Accordingly, income taxes paid to that other country on that income will generally be creditable (subject to any relevant limitations) in the country of residence.

The general source rule (described above) does not apply to income derived by an Italian resident that is taxable in the United States solely by reason of U.S. citizenship. Such income will not be treated as U.S. source income. Income of a U.S. citizen resident in Italy is to be treated as Italian source income to the extent necessary to implement a special treaty rule, described below, that

allows primary taxing jurisdiction to the United States on the U.S. source income of such a U.S. citizen while allowing primary taxing jurisdiction to Italy on the non-U.S. source income of such a person.

The proposed treaty provides a special rule for U.S. citizens that are Italian residents. Such persons are entitled to a credit against U.S. tax liability in the amount of the Italian tax paid. Thus, Italy generally would have primary residence taxing jurisdiction over the income of such persons, and the United States would deem the income that Italy taxes on this basis to arise in Italy (for the limited purpose of crediting these Italian taxes). This U.S. tax credit is not to reduce U.S. taxation on a source basis of such a person's U.S. source income. This rule will not operate to increase such a person's U.S. foreign tax credit limitation so as to enable him or her to credit any additional non-Italian taxes.

The treaty does not affect the U.S. treatment of taxes not covered by Article 2 (Taxes Covered), whatever the source of the affected income under the treaty. The treaty's source rules do not apply for purposes of computing the limitation for other foreign taxes.

Article 24. Non-discrimination

The proposed treaty contains a non-discrimination provision relating to the taxes covered by the treaty similar to provisions which have been embodied in other recent U.S. income tax treaties. This non-discrimination provision applies not only to the taxes that the treaty covers generally, but also to all taxes that either country or any of its political or administrative subdivisions or local authorities impose.

In general, under the proposed treaty, one country cannot discriminate by imposing more burdensome taxes (or requirements connected with taxes) on nationals of the other country than on its own nationals in the same circumstances. This provision applies whether or not those nationals are residents of the United States or Italy. However, for the purposes of United States tax, a U.S. citizen who is not a resident of the United States and an Italian national who is not a resident of the United States are not in the same circumstances, because the U.S. citizen is subject to U.S. tax on his worldwide income.

The proposed treaty adopts the OECD model treaty definition of "nationals." Nationals are individuals possessing the citizenship of the United States or Italy and all legal persons deriving their status as such from the laws in force in the United States or Italy. Under the U.S. model treaty, by comparison, only U.S. citizens qualify as U.S. nationals for purposes of obtaining non-discrimination benefits.

Similarly, in general, one country cannot impose less favorable taxes on permanent establishments of enterprises of the other country than it imposes on its comparable enterprises. However, a country need not grant to residents of the other country the personal allowances, reliefs, or reductions for taxation purposes on account of civil status or family responsibilities that it grants to its own residents.

Each country is required (subject to the arm's-length pricing rules of Articles 9 (Associated Enterprises), 11(7) (Interest), and 12(6) (Royalties)) to allow an enterprise to deduct interest, royalties, and all other disbursements paid by the enterprise to a resident of the other country under the same conditions that they allow deductions for such amounts paid to residents of the same country as the payor.

The rule of non-discrimination also applies to enterprises of one country which are owned in whole or in part by residents of the other country. An enterprise resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, would not be subject in the country of its residence to any taxation or any connected requirement which is more burdensome than the taxation and connected requirements that the country of its residence imposes or may impose on its enterprises carrying on the same activities but the capital of which is owned or controlled by its residents.

The non-discrimination provisions do not generally require either country to treat nonresidents as it treats residents. The non-discrimination provision does not override the right of the United States to tax foreign corporations on their dispositions of a U.S. real property interest because the effect of the provisions imposing the tax is not discriminatory.

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to this non-discrimination article.

Article 25. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes the competent authorities of both the United States and Italy to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by a substantive provision of the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Generally, under the proposed treaty, a resident of one country who considers that the action of the countries or either of them will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. If the ground for complaint arises under Article 23 (Relief from Double Taxation) (which generally requires allowance of a foreign tax credit) or under Article 24 (Non-discrimination), however, the taxpayer is to notify the country of which he is a national.

An adjustment of taxes pursuant to this Article may be made only prior to the final determination of the taxes whose adjustment is sought (Article 1, paragraph 15 of the proposed protocol). In the case of Italy, invocation of the mutual agreement procedure does not relieve a taxpayer of the obligation to initiate the procedures of Italian law for resolving tax disputes. Upon notification, the competent authority makes a determination as to whether the objection appears justified. If the objection appears to it to be justified and if

it is not itself able to arrive at a satisfactory solution, then that competent authority would endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the Convention. The provision requires the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. The provision, however, does not authorize the imposition of additional taxes after the statute of limitations has run.

The competent authorities of the Contracting States are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation of application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty.

Unlike the U.S. model, the proposed treaty does not list particular matters to which the competent authorities might agree. However, it is intended that, as under the U.S. model, the competent authorities would be authorized to agree to the allocation of income, deductions, credits, or allowances, to the determination of the source of income, and to the common meaning of terms.

The treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of the mutual agreement provision. These provisions make clear that it is not necessary to go through standard diplomatic channels in order to discuss problems arising in the application of the treaty and also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Italy.

Article 26. Exchange of Information

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to enable them to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or of the domestic laws of the two countries concerning taxes covered by the treaty insofar as the taxation under those domestic laws thereunder is not contrary to the treaty. In addition, the proposed treaty expressly authorizes the exchange of such information as is necessary for the prevention of fraud or fiscal evasion. The exchange of information is not restricted by Article 1 (General Scope). Therefore, the countries could exchange information about third country residents. The U.S. model treaty provides for the exchange of information about all taxes imposed by either country (whether or not otherwise covered by the treaty). The proposed treaty is more limited, applying only to require exchange of information relevant to the for assessment of the taxes listed in Article 2 as covered by the treaty (generally income taxes) (Article 1, paragraph 16 of the proposed protocol).

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. Exchanged information is to be disclosed only to persons or authorities (including courts and ad-

ministrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the treaty. Such persons or authorities could use the information for such purposes only, but may disclose the information in public court proceedings or in judicial decisions. The appropriate Committees of the U.S. Congress and the U.S. General Accounting Office are to have access to the information exchanged under the proposed treaty where such access is necessary to carry out their oversight responsibilities, subject only to U.S. statutory limitations and procedures (Article 1, paragraph 16 of the proposed protocol).

Under the proposed treaty, a country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

The U.S. model treaty provides that each country will collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. Article 6 of the proposed protocol contains a similar provision.

Article 27. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the convention will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply to this article, so that, for example, U.S. diplomats who are considered Italian residents would not be subject to Italian tax.

Article 28. Entry Into Force

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country and the instruments of ratification are to be exchanged as soon as possible in Washington. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged.

With respect to taxes withheld at source, the treaty will be effective for amounts paid or credited on or after the first day of the second month next following the date on which the treaty enters into force. With respect to other taxes, the treaty is to be effective for taxable periods beginning on or after January 1 of the year in which the treaty enters into force. This retroactive effective date is unusual: for nonwithholding taxes, U.S. treaties generally take effect for taxable years beginning on or after some date after entry into force. However, for that first taxable period in which the new treaty is effective, taxpayers have their choice of the existing (1955) treaty with Italy or the proposed treaty. Taxpayers may choose between the two treaties on a provision-by-provision basis. This abili-

ty to choose between the two treaties for the first taxable period of the proposed treaty's application applies to withholding taxes as well as other taxes.

The existing treaty between the United States and Italy and and exchange of notes concerning the existing treaty will terminate as the proposed treaty becomes effective. When the proposed treaty becomes fully effective, the existing treaty will cease to have effect. In addition, the proposed treaty will terminate a 1926 U.S.-Italian shipping treaty.

Article 29. Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after five years from its entry into force by giving at least six months prior notice through diplomatic channels.

If termination occurs, with respect to taxes withheld at source, the termination will be effective for amounts paid or credited on or after the first day of January next following the expiration of the six month period. With respect to other taxes, the termination will be effective for taxable periods beginning on or after the first day of January next following the expiration of the six-month period.

Proposed Protocol

A proposed protocol to the treaty was signed at the time the proposed treaty was signed. The proposed protocol clarifies certain points raised in the treaty and contains substantive changes to the treaty.

Article 1

Article 1 of the proposed protocol modifies specific Articles of the proposed treaty. Discussions of those modifications appear in the discussions of the affected articles, above.

Article 2

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Italy as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. Such use is known as "treaty shopping", and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. In certain circumstances, and without appropriate safeguards, the nonresident is able to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third country resident to repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed protocol contains provisions intended to limit the use of the treaty to bona fide residents of the two countries. This is accomplished by providing that a person other than an individual (such as a corporation, partnership, trust, or other business organization) is not entitled to certain benefits of the convention unless it satisfies any one of an ownership test, a public company test, or a good business purpose test. Under the ownership test, more than 50 percent of the beneficial interest (in the case of a company, more than 50 percent of the number of shares of each class of shares) in that entity must be owned directly or indirectly by any combination of one or more individual residents of Italy or the United States, citizens of the United States, publicly traded companies (discussed below), or the countries (the United States and Italy) themselves. This provision would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends, interest or royal-

ties to a Italian company that is owned by individual residents of a third country.

Under the public company test, a company that has substantial and regular trading in its principal class of stock on a recognized stock exchange (a term defined below) is entitled to the benefits of the treaty regardless of where its actual owners reside. The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc. in the United States; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; any stock exchange constituted and organized according to Italian law; and any other stock exchange agreed upon by the competent authorities of the two countries.

Under the good business purpose test, denial of treaty benefits does not occur if it is determined that the acquisition, ownership and maintenance of an entity that is a resident of the United States or Italy and the conduct of its operations did not have as one of their principal purposes the purpose of obtaining benefits under the proposed treaty. Accordingly, the provision will not apply if there was no treaty shopping motive for forming the company and if its operation does not have as one of its principal purposes the purpose of obtaining the treaty benefits. The burden of overcoming the treaty shopping rule, as under U.S. tax law generally, is on the taxpayer claiming treaty benefits.

Article 3

Article 3 of the proposed protocol contains the standard rule that the treaty will not restrict any benefit for taxpayers under U.S. or Italian domestic law or under any other agreement between the United States and Italy. That is, the treaty will operate only to benefit taxpayers.

Article 4

This article provides that a U.S. citizen and Italian resident who is a partner in a U.S. partnership is entitled to a refundable credit against his or her Italian individual income tax (l'imposta sul reddito delle persone fisiche) for the taxable period that equals the portion of his Italian corporate tax (l'imposta sul reddito delle persone giuridiche) that is attributable to his or her share of the partnership income. In other words, Italy agrees to treat a U.S. partnership in the way that the United States treats it, as a flow-through entity for tax purposes, when the partner whose tax is at issue is a U.S. citizen who is an Italian resident.

Article 5

This article provides for one method by which the competent authority of one of the two countries may allow the reduced withholding tax rates of the proposed treaty. The article establishes rules that will apply if either country establishes a refund system for withholding taxes whose rates the treaty reduces. In the case of such a refund system, the source country will withhold taxes at the

regular rate, without regard to treaty reduction of that rate. Thereupon, the taxpayer receiving the income is to make to the source country a claim for refund (within the time fixed by law of the source country) and to furnish with the claim an official certificate of his residence country that certifies the existence of the conditions allowing the reduced treaty rate to that taxpayer. The proposed treaty does not obligate the United States or Italy to establish a refund system. The United States does not now use such a system. Proposed Treasury Regulations would impose a certification system for certain payments of U.S. source income that are subject to reduced withholding taxes by treaty. Under this system, the person claiming the benefits of a treaty must furnish a certificate from his residence country that allows reduction of the tax without delay.

Article 6

This article, like the U.S. model treaty, provides that each country will collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. This treaty obligation would not oblige either country to use administrative measures that it would not use in collecting its own tax or that would be contrary to its sovereignty, security, or public policy.

Article 7

This article provides rules for the entry into force and effect of the proposed protocol that correspond to the comparable rules for the proposed treaty (Article 28).

Article 8

This article provides that the proposed protocol will remain in force as long as the proposed treaty does.

Exchange of Notes

An exchange of notes on the date of signing of the proposed treaty and the proposed protocol concerns two issues of taxation by states of the United States. The first issue is the worldwide unitary apportionment method of taxation that several states of the United States use to tax companies with operations outside the United States. Italy takes the position that the worldwide unitary method, as states use it to calculate the income of U.S. offices or subsidiaries of Italian corporations, results in unfair taxation and undue administrative burdens. In addition, Italy criticizes the requirement of unitary states that Italian multinational companies submit, in English, the books and record of subsidiaries that operate outside the United States. Italy expresses its concern about the unitary method, and notes that the Senate refused to accept a treaty with the United Kingdom that would have restricted state use of the unitary method. In the exchange of notes, the United States agrees to reopen discussion with Italy on the subject of the use of the unitary method by states "if an acceptable provision on this subject can be devised." Italy also reserves the right to reopen discussions with the United States if, after April 17, 1984 (the date of the exchange of notes), any U.S. State changes its method of taxation in such a way as to have a substantial negative effect on Italian residents.

The second issue of state taxation that the exchange of notes addresses concerns taxation of income from the operation in international traffic of ships or aircraft. If any U.S. state or locality imposes tax on income of an Italian enterprise from such operations, then Italy may impose its local income tax (ILOR) on similar profits of U.S. enterprises, notwithstanding the specific prohibition of such taxation in the proposed treaty (Article 8).

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